Privatization and Public Enterprises

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The following symbols have been used throughout this paper:

... to indicate that data are not available;
— to indicate that the figure is zero or less than half the final digit shown, or that the item does not exist;
– between years or months (e.g., 1984–85 or January–June) to indicate the years or months covered, including the beginning and ending years or months;
/ between years (e.g., 1985/86) to indicate a crop or fiscal (financial) year.

“Billion” means a thousand million.

Minor discrepancies between constituent figures and totals are due to rounding.
Prefatory Note

This paper was prepared by Richard Hemming and Ali M. Mansoor of the Fund's Fiscal Affairs Department, and Joslin Landell-Mills provided editorial assistance. The views expressed are those of the author and do not purport to represent those of the International Monetary Fund.

It should be noted that the term “country” used in this document does not in all cases refer to a territorial entity that is a state as understood by international law and practice. The term also covers some territorial entities that are not states but for which statistical data are maintained and provided internationally on a separate and independent basis.
I Introduction

The word "privatization" entered popular usage only recently, and certainly the activity with which privatization has become most closely associated—the sale of public sector assets—is a distinct phenomenon of the 1980s. However, like the word itself, the various activities that have been described as privatization can claim a longer history.¹ Policies designed to stimulate the substitution of private for public provision of various goods and services are not a recent innovation. But the wide range of public sector activities that are now being considered for privatization, the various methods being suggested to achieve this objective, and the enthusiasm with which privatization policy is in some cases being pursued distinguishes current privatization efforts from previous ones.

The growing appeal of privatization, especially in industrial countries, can in part be traced back to economic developments in the mid-1970s. Rapid public sector expansion in the 1960s and early 1970s was, at the time, seen as a major contributor not only to economic growth but also to social and political stability. The expanding role of the public sector in the economy was rarely challenged. But the situation changed drastically in the mid-1970s, when the inability of economies to adjust to external price shocks—in particular, the first round of oil price increases—led to a marked deterioration in macroeconomic performance. Subsequent recovery was slow, and part of the blame was leveled at large public sectors, which, it was argued, robbed the economy of the flexibility it needed to achieve the necessary adjustment. At the same time, both the efficiency and effectiveness of public sector activities began to be questioned seriously. In a number of countries—most notably the United Kingdom and the United States—the backlash against the public sector was given additional impetus by the election of governments pledged to reducing the size and scope of government. To varying degrees, and in all its forms, privatization was expected to play a significant role in achieving such a reduction.

Privatization has also been frequently recommended for developing countries, where the industrial sector and, occasionally, key elements in the commercial sector, are heavily dominated by public enterprises. Loss-making enterprises have, for many years, been a drain on government resources in these countries. Such enterprises have required direct budgetary transfers or have relied on government-guaranteed borrowing to finance their cash operating losses. Recently, the wider macroeconomic problems that have afflicted developing countries have forced them to reconsider their strategies for dealing with public enterprises. In particular, many of the countries that have adopted Fund-supported adjustment programs have been trying to address the problems that give rise to the need for financial support of public enterprises, and privatization has, in a number of cases, been considered as a way of relieving governments of their heavy involvement in industry and commerce.²

This paper will examine the role that privatization can play within a wider strategy designed to overcome the problems associated with public enterprises. For this purpose, privatization is defined as a transfer of ownership and control from the public to the private sector, with particular reference to asset sales. It is therefore equated with total or partial denationalization. The paper will for the most part skirt the detail of privatization initiatives in various countries—many of which have been reviewed elsewhere (see Berg (1983) and (1985))—and try to address some general issues that arise in evaluating the potential role of privatization. Section II briefly reviews the arguments used to support public production and nationalization, discusses the performance of public enterprises, and identifies the problems to which privatization can be seen as a direct response. These problems include the tendency for politicians to interfere in public enterprise operations; the inability of politicians and civil servants to monitor enterprise managers effectively; inappropriate managerial incentives; and the availability of financial support from the government with only limited constraints. As a consequence, public enterprises are often inefficient and incur losses. Advocates of privatization claim that it will lead to improved economic performance as the scope for political interference is limited, the discipline of the private capital market is imposed, and managerial incentives are improved. It is also claimed that

¹The words "privatize" and "privatization" appeared for the first time in the 1983 edition of the Webster's Ninth New Collegiate Dictionary, where their earliest recorded use is given as being in 1948. However, S.H. Hanke claims responsibility for popularizing these words while serving on the U.S. President's Council of Economic Advisers in 1981 and 1982 (Washington Post, January 13, 1986).

²See International Monetary Fund (1986) for a listing of Fund supported adjustment programs for the period 1980-84 containing references to privatization.
privatization will reduce the budgetary cost associated with inefficiency; in addition, any sale proceeds will directly benefit public finances. Section III outlines these and other arguments used in support of privatization, while also focusing on techniques of privatization and problems of implementation, in particular, asset valuation, marketing, and financing. These problems are illustrated with country experiences, especially the ambitious program of asset sales under way in the United Kingdom and France.

Sections IV and V examine, in analytical terms, the likely impact of privatization. While changes in ownership can lead to increases in productive efficiency (that is, to lower production costs), the paper points to the possibility that such increases may be only modest. Significant gains in efficiency are most likely to result from the privatization of some of the major public monopolies, but only if this results in their being exposed to competition. The transfer of a public monopoly to the private sector, with its monopoly power left intact, may achieve only limited increases in productive efficiency. Moreover, it is unlikely to increase allocative efficiency—that is, to lead to a structure of output more highly valued by consumers given social costs of production. If the opportunity to secure economic efficiency—that is both productive efficiency and allocative efficiency—is to be fully exploited, privatization should be accompanied by liberalization, to foster competition, and by regulation, to prevent anticompetitive practices.

In economic terms, the scope for effective privatization in the public enterprise sector depends upon a number of considerations: whether private sector managers have a greater incentive than public sector managers to seek out opportunities to improve efficiency; the number of public enterprises facing national or international competition; the extent to which public monopolies should be regarded as “natural”; and the importance of social and other non-commercial (such as macroeconomic) objectives. In view of such considerations, privatization is not likely to be extensive relative to the size of public enterprise sectors in either industrial or developing countries. As a result, the improvement of incentive mechanisms and statutory and administrative procedures currently employed to secure economic and financial control of public enterprises, as well as the search for alternatives to privatization, will need to be given a high priority. Regarding public finances, it is argued that changes in ownership alone offer few lasting budgetary benefits unless privatization is associated with increased efficiency.

Section VI discusses the implications for adjustment policies arising from the principal conclusions of this paper. Privatization should be encouraged to the extent that it fosters more active competition and improves existing incentive and control mechanisms for public enterprises. It should be noted, however, that if privatization involves no more than a transfer of activities from the public to the private sector, it may yield only limited gains.


II Public Enterprises and the Economy

The economic case for privatization is made by reference to public ownership that is more extensive than can be justified in terms of the appropriate role of public enterprises in mixed economies, the poor economic performance of public enterprises compared with private enterprises, and the inherent characteristics of public ownership that give rise to inefficiency. The objectives and performance of public enterprises, and the problems associated with public ownership, are described in this section.

Objectives

The size and structure of the public enterprise sector vary significantly within groups of otherwise comparable industrial and developing countries. For example, in the non-socialist industrial countries, the share of public enterprise output in gross domestic product (GDP) in the mid-1970s varied from 4 percent in the Netherlands and Spain to 15 percent in Austria. Similarly, among non-socialist developing countries, the shares varied from 1 percent (Nepal) to 14 percent (Taiwan, Province of China) in Asia; 7 percent (Liberia) to 35 percent (Zambia) in Africa; 1 percent (Guatemala) to 38 percent (Guyana) in Latin America; and 4 percent (Malta) to 14 percent (Portugal) in Europe (Short, 1984). This heterogeneity—which applies not only to the size but also the structure of the public enterprise sector—reflects the range of considerations that led to the decision to undertake a particular activity in the public sector.

From the standpoint of economic analysis, public ownership has most commonly been viewed as a response to the failure of private markets to secure efficient outcomes. Market failure can occur for a number of reasons, and public production in various areas can be justified by reference to particular sources of market failure. Thus, public goods like defense and police services are provided in the public sector because they are nonexcludable (giving rise to “free-rider” problems), state-mandated environmental protection is necessary because the market does not take account of externalities, and informational asymmetries are used to justify the public provision of medical care. In the case of the traditional public enterprises, in particular those involving the use of networks (power generation and distribution, water supply, telecommunications, and transportation), the possible emergence of a natural monopolist—that is, a situation where only a single producer can exploit available economies of scale—is the principal concern.

In these areas and others, however, market failure has often tended to serve as an ex-post justification for nationalization. Moreover, while market failure can provide a strong rationale for government intervention, it does not follow that intervention must take the form of public ownership. For example, the economic objectives of nationalization can be and have been achieved through the use of regulatory controls, legal sanctions, taxes, transfers, and subsidies. To explain why the preferred mode of intervention has so often been nationalization, and why the public sector now encompasses activities that lie well outside the traditional domain, especially in developing countries, it is necessary to look to a wider concept of market failure.

An important group of arguments—some clearly of an economic character, others more of a political/ideological nature—relates to economic development and planning. In many developing countries, public production was viewed as essential given the underdeveloped nature of resources and markets. In general, private returns to investment were not sufficiently attractive to private investors, and few native entrepreneurs with investable funds were either willing to bear the risk or were capable of running modern enterprises. Also, the scale of investment required often exceeded the capital-raising capacity of the indigenous private sector. Public ownership and control of the “commanding heights” of the economy was given special emphasis in this context, in both industrial and developing countries.

Substantial social benefits were also expected to derive from the creation of public enterprises. In many cases, public ownership was thought to be conducive to the attainment of a number of social policy aims. The inability of the market to achieve distributional objectives—in particular, widespread access to essential goods and services (so-called merit goods) at reasonable prices—is a source of market failure in the standard sense. But public ownership has been ascribed wider social objectives. For example, it has been used to create employment or to prevent rising unemployment. Of particular concern have been the social costs imposed when a locality or region is dominated by a firm or industry that is experiencing financial problems. The extension of public ownership to many areas of manufacturing industry—both declining indus-
tries (those with poor demand prospects) and those suffering temporary difficulties—is often related to the adverse employment consequences of continued private ownership and the possibility of bankruptcy. The social goals of public ownership take on particular significance in developing countries, where unemployment and inequality are more readily associated with political instability.

Nationalization can also serve strategic interests. A country that retains an interest in major world industries, even where it is inefficient to do so, will not depend on potentially unreliable external sources of supply.

Public ownership has also been advocated as a political strategy, although political intent has frequently been masked by reference to economic and social considerations. While there are clear examples of nationalization (and denationalization) that reflect a prevailing political ideology, the existence of genuine economic and social benefits provide for many instances of inconsistency. As a result, there is little correlation, both across countries and over time, between political stance and the size of the public enterprise sector.

While all of the above considerations help to account for the central role currently assigned to public enterprises in both industrial and developing countries, they do not fully explain why the boundary between the private and public sectors differs so much across countries. Because so many extraneous and arbitrary factors come into play, it is impossible to predict the size and structure of the public sector of a given country, even taking into account its economic, social, political, and other seemingly relevant characteristics. Indeed, in many instances, an enterprise ends up in the public rather than the private sector largely through an accident of history.

Performance

A growing body of evidence claims to show that when the public and private sectors can be compared in terms of the cost of producing similar outputs, the private sector outperforms the public sector. For example, Borcherding, Pommerehne, and Schneider (1982) summarize the results of a number of studies covering a wide range of activities (including air, bus and rail transport, electric and water utilities, and insurance) in the United States, the Federal Republic of Germany, Australia, Canada, and Switzerland—countries with allegedly similar social and political institutions—that support this view. But such results should be treated with caution. Given the objectives of nationalization, it should not be surprising that there are few examples of truly comparable public and private sector activities and enterprises. Attention therefore focuses on specific aspects of comparability; however, as the focus of attention changes, the results of such comparisons also tend to change.\(^4\)

The results may also change over time, both in the long term and the short term. For example, impetus was given to creating municipal enterprises in Italy at the end of the nineteenth century by studies comparing similar private and public enterprises which clearly showed inefficiency in the private sector (Marchese (1985)). However, while once viewed as a model of successful nationalization, it is alleged that the public enterprise sector in Italy is now riddled with inefficiency and corruption (Martinelli (1980)). The relative inefficiency of the private sector in the United Kingdom was discussed by Pryke (1971) whose later work (1982), on the other hand, showed the private sector to be more efficient than the public sector. But perhaps the major limitation of such comparisons arises from the fact that public enterprises are assigned multiple objectives—including social obligations to deliver essential services, sell at below cost (which may involve cross-subsidization), and provide employment—and to the extent that these objectives must be traded off against commercial objectives, public enterprises are bound to appear less efficient in terms of the criteria by which private enterprises are judged.

Despite the inconclusive nature of the evidence, it is difficult to believe that existing public enterprises are not capable of improving efficiency significantly, be it in the public or the private sector. Moreover, increasing budgetary support for public enterprises suggests that their performance has been deteriorating, particularly in developing countries.\(^4\) To reverse this trend, the major sources of inefficiency need to be identified.

Problems

Many of the early proponents of government ownership argued that socialized industry could be self supporting and economically successful only if it were freed from political interference. While public enterprises should be accountable to government, day-to-day decision making should be left to enterprise managers. This has been referred to as the “arm’s length principle.” In practice, public enterprises are subject to a wide range of statutory and administrative controls, as well as to less formal modes of intervention. Government influence extends well beyond that necessary to ensure that enterprises fulfill their economic, financial, and social objectives. Indeed, a significant part of the problem is that politicians can influence the objectives of public enterprises; in particular, less compelling noncommercial objectives are substituted for economic, financial, and more immediate social objectives. Notwithstanding the claim that some countries have

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\(^4\)Although there are notable exceptions (such as Argentina and India), the World Development Report 1983 of the World Bank provides a number of examples of countries where budgetary support was much higher toward the end of the 1970s than in the late 1960s and early 1970s. However, part of this increased support will have been necessitated by worsening economic conditions rather than increasing inefficiency.
Problems experienced a recent improvement in the relationship between politicians and public enterprises (see, for example, Posner (1984)), in many countries it is unlikely that politicians can be persuaded to interfere much less than in the past.

It has also been suggested that in choosing to locate an activity in the public sector, market failure has given way to bureaucratic failure. For example, property rights (or agency) theory suggests that, because they do not have access to shared information, governments (the principals) face difficulties in providing appropriate incentives to public sector managers (their agents) and in monitoring their performance. Managers are therefore given less discretion than their private sector counterparts and so choose a relatively quiet life (Alchian (1965)). They will perform only to the level necessary to meet the performance standards set for them, and these may be modest compared with the potential of the firm or industry concerned. From a different perspective, public choice theory suggests that public managers can secure more pay, power, and prestige than their private sector counterparts by forming coalitions with civil servants in supervising ministries that result in increased budgets (Niskanen (1971)). Indeed, budget maximization becomes an end in itself, and other objectives—both commercial and noncommercial—have to be conceded to achieve it. While these two theories imply different behavior on the part of public sector managers—and so far the available evidence is incapable of distinguishing between them—both theories predict that public production will be relatively inefficient.

Political interference and bureaucratic failure are probably the principal sources of inefficiency associated with public ownership. There are, however, other important sources of inefficiency. For example, with government backing public enterprises cannot go bankrupt, and they do not face the risk of take-over; they are not, therefore, forced to observe the financial discipline imposed on the private sector. Specifically, public enterprises either do not have to borrow on the private capital market, or, if they do, government guarantees or the assumption of government backing results in their being favorably treated relative to private enterprises. This, of course, accommodates the inefficiency resulting from political interference and bureaucratic failure. It also allows public sector unions to exploit their power to interrupt the supply of essential goods and services to secure pay and conditions that are out of line with those in the private sector. In developing countries, it is also argued that limited human resources are spread too thinly over large public enterprise sectors. The above problems suggest that public enterprises will perform badly in terms of productive efficiency, because they are likely to have higher production costs at a given level of output than comparable enterprises in the private sector.

It is also alleged that public enterprises fail to achieve allocative efficiency, because they have little incentive to respond to consumer demands; the quantity, quality, and other characteristics of goods and services provided by public enterprises are not those most valued by consumers. While public ownership per se may lead to productive inefficiency, it can result in allocative inefficiency only when associated with considerable monopoly power—which is often granted by statute—or when some other form of protection from competitive pressures—usually the result of inappropriate financial and trade policies—is implied.  

Allocative efficiency can also be defined in terms of resource allocation in the economy as a whole. Focusing on efficiency in consumption given production decisions implies that productive and allocative efficiency can be discussed independently. A partial equilibrium view of economic efficiency is therefore being taken. In a general equilibrium analysis, productive inefficiency would imply allocative inefficiency—because inputs are allocated inefficiently and there exists a Pareto superior structure of output and consumption—although the reverse would not be true.
The poor performance of public enterprises can be tackled in a variety of ways, and privatization is not the first to be tried. As mentioned above, previous efforts have involved statutory and administrative measures to control public enterprises. Because these have for the most part been judged unsuccessful, attention is now turning to the possibility of increasing private sector involvement in public enterprises. This can be achieved to different degrees, but it is privatization in the form of denationalization that is attracting the greatest interest.

**Benefits**

Privatization is seen primarily as a means of improving the efficiency of enterprises. Because it is believed to limit the scope for political interference in decision making, to increase managerial incentives by making managers responsible to shareholders who will monitor their performance better than governments, and to impose the financial discipline of private capital markets (including the market for corporate control), there is likely to be an incentive to seek productive efficiency, and fewer barriers to attaining it.

Other benefits are also claimed. Through privatization, an enterprise can gain access to private sector financing, and private owners may bring access to new markets. If the sale of public sector assets can be made attractive to small investors, this will broaden share ownership, which may be thought desirable. Privatization may also spur the development of domestic capital markets, and, it has been argued, lead to a reduction in public sector deficits, especially if the government can dispose of loss-making enterprises. In addition, it may disarm public sector trade unions that are abusing a monopoly position. Advocates of privatization also tend to associate it with increased competition and hence improvements in allocative efficiency.

Privatization may also benefit enterprises that remain within the public sector. For these enterprises, increased efficiency will result principally from improvements to existing incentive and control mechanisms. If a significant number of public enterprises can be transferred to the private sector, the government should be better placed to focus on the objectives, conduct, and performance of those enterprises that it remains responsible for. There is also a potential role for such privatization techniques as contracting out and franchising, which fall short of total or even partial denationalization.

The main arguments made in support of privatization are discussed later in the paper. In particular, Section IV examines efficiency issues while Section V analyzes the impact of privatization on government finances. The remainder of this section focuses on techniques of privatization, national experiences and prospects, and practical problems of implementation.

**Techniques**

The term “privatization” has been used to refer to any shift in activity from the public to the private sector. This could involve no more than the introduction of private capital or management expertise into a public sector activity. For the moment, however, we will concentrate on the transfer of ownership of public enterprises to the private sector. Ownership can be transferred in a variety of ways. An enterprise may be sold in its entirety to a buyer in private industry engaged in a similar activity or seeking to diversify; to the management and employees; or to the public through a share issue. Alternatively, a part of the whole may be sold, probably to a private buyer with a related interest. This may be appropriate where the enterprise as a whole is not attractive to a private buyer—because some of its activities are heavily regulated, for example—but where other activities can be separated from the whole and run independently. Where salable parts cannot be identified, a proportion of the whole can be sold, the exact percentage depending upon how much control the government wishes to retain over the enterprise.

A change in ownership need not involve a sale. An enterprise can be privatized by handing over ownership by means of, say, a nominal sale to a private individual, to a private concern, or to a particular interest group, most likely the management or employees of an enterprise. Such a “giveaway” may be appropriate where heavy losses, massive debts, or a history of labor troubles make an enterprise unattractive to a specific buyer or to the wider public. As a final resort, an enterprise can simply be liquidated, and its plant and equipment sold off to the
private sector. There are many other privatization techniques—Pirie (1985) identifies over twenty—but they do not involve changes in ownership.

Once privatization is adopted as a policy, a number of practical problems, such as asset valuation, marketing, and financing, have to be addressed before it can be implemented. The following section reviews recent privatization developments and what is in immediate prospect. It cites specific examples of the problems associated with privatization, particularly in the United Kingdom, where sales of public sector assets have been extensive. This review serves to illustrate some of the problems that are then discussed.

Experiences and Prospects

The United Kingdom

As of April 1987, the United Kingdom had raised £12.0 billion through a privatization program that commenced in 1979. The sale of a majority stake in British Telecom yielded £4.1 billion, while the sale of British Gas (the largest share issue ever made), which so far has generated £1.8 billion, will eventually yield £5.1 billion. Details of the major enterprise sales are shown in Table 1.\(^1\) In each case, sale was by one of two methods or a combination of both, namely, the sale of equity by tender and offers for sale at a fixed price. The latter has been the more common. Both types of sale presented problems, with tenders failing to reach reserve prices and, most notably, offers being oversubscribed, the market initially establishing large discounts, with the offer price significantly below the subsequent market price.

Determining the market price of a public enterprise in advance of a sale is difficult since there is very little information on which to base an estimate. Selling by tender would, therefore, seem to be logical, especially where the enterprise has no private sector comparator. However, this has been regarded as too complex a method of sale to secure the participation of small investors, which is an objective of privatization policy in the United Kingdom. Offers for sale have met with some or all of the problems mentioned above. For example, in the case of Amersham International, a small radionics firm, an offer for sale of 100 percent of equity in 1982 was oversubscribed 25 times. The sale yielded £64 million. Subsequent trading established an immediate discount of over 30 percent on the sale and most of the original 65,000 shareholders sold out to the large institutions at a considerable profit.

Table 1. United Kingdom: Privatization of Major Public Enterprises, February 1981 to January 1987

<table>
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<th>Date</th>
<th>Enterprise</th>
<th>Proceeds (In millions of £)</th>
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<tr>
<td>February 1981</td>
<td>British Aerospace</td>
<td>43</td>
</tr>
<tr>
<td>October 1981</td>
<td>Cable &amp; Wireless</td>
<td>181</td>
</tr>
<tr>
<td>November 1983</td>
<td>Britoil</td>
<td>627</td>
</tr>
<tr>
<td>December 1983</td>
<td>Cable &amp; Wireless</td>
<td>263</td>
</tr>
<tr>
<td>June 1984</td>
<td>Enterprise Oil</td>
<td>382</td>
</tr>
<tr>
<td>July 1984</td>
<td>Jaguar Cars</td>
<td>297</td>
</tr>
<tr>
<td>November 1984</td>
<td>British Telecom</td>
<td>4,090</td>
</tr>
<tr>
<td>May 1985</td>
<td>British Aerospace</td>
<td>346</td>
</tr>
<tr>
<td>August 1985</td>
<td>Britoil</td>
<td>426</td>
</tr>
<tr>
<td>December 1985</td>
<td>Cable &amp; Wireless</td>
<td>571</td>
</tr>
<tr>
<td>December 1986</td>
<td>British Gas</td>
<td>1,796</td>
</tr>
<tr>
<td>January 1987^3</td>
<td>British Airways</td>
<td>415</td>
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Source: Yarrow (1986), Table 1; and data provided by the United Kingdom authorities.
\(^1\) Dates shown indicate initial offering.
\(^2\) Of which £334 million in 1982/83 and £293 million in 1983/84.
\(^3\) Of which, £1,352 million in 1984/85, £1,246 million in 1985/86, and £1,084 million in 1986/87. Also included is £408 million generated by the sale of British Telecom stock and preference shares.
\(^4\) Total estimated proceeds are £5,090 million, with the second installment having been due in June 1987 and the third installment due in April 1988.
\(^5\) Including £750 million of British Gas debt was redeemed in May 1987.
\(^6\) Total estimated proceeds are £825 million, with the second installment paid in August 1987.

This is not an isolated example. Mayer and Meadowcroft (1985) reported that oversubscription and an average discount of 26 percent on a range of sales between 1979 and 1985.\(^8\) They also report that in most cases subsequent trading resulted in a large reduction in the number of people holding shares in the enterprises concerned. Only in the case of Britoil did the number of shareholders subsequently increase, but the sale by tender of the first tranche of Britoil shares was initially unattractive to small investors. In the case of British Telecom, the government took a number of measures to encourage share purchases, and persuade shareholders to hold on to their initial allocation. These efforts appear to have succeeded, despite an immediate discount of almost 100 percent, and a larger subsequent discount. The original 2.3 million shareholders have only fallen to about 1.7 million. More extensive measures accompanied the sale of British Gas, and these resulted in over 4 million successful applications for shares. These measures, combined with a relatively modest discount of about 20 percent appear to have persuaded shareholders, on the whole, to retain their initial allocations.

The experience in the United Kingdom with other forms of asset transfer is limited. There have been a number of instances of complete parts of a whole enterprise being sold—for example, the sale of hotels and the cross-Channel ferry service run by British Rail, a communications subsidiary of British Airways, and a subsidiary of the British Steel Corporation. The National Freight...
Company and the Redheads ship repair yard were sold to their workforces. And, in one case, an operation—the cross-Channel hovercraft service run by British Rail—was given to its workforce.

Notwithstanding the problems associated with offers for sale, recent figures suggest that privatized enterprises have improved their profits and the managers of some of these enterprises attribute the improvement mainly to the freedom to pursue commercial objectives unhindered by government interference in decision making. 9 It is important to note, however, that much of the improvement in profitability occurred over a period when the economy was recovering from a major recession. In many cases profits were increasing prior to privatization, and enterprises that remained in the public sector were also reporting better financial results. It is therefore not clear what part privatization has played in this improvement. 10 The only failure in this respect has been the Redheads ship repair yard, which was in severe financial trouble less than two years after privatization and was subsequently taken over by another ship repair yard. This was not wholly unexpected, and should not be regarded as reflecting badly on the privatization strategy; since an objective of privatization is to separate those commercial enterprises that can compete in the private sector from those that cannot, it represents a successful aspect of the strategy.

While there must remain some uncertainty as to the overall economic impact of the U.K. Government's privatization program, it has clearly caught the imagination of the British public (of whom eight to nine million were shareholders in privatized enterprises in 1987) and created interest throughout the world. The U.K. Government has recently announced plans to privatize the British Airports Authority; attention is then expected to turn to the electricity supply industry, with the nationalized steel, coal, railway, and water supply sectors representing possible but less likely candidates for privatization.

France

The French Government announced a five-year privatization plan in mid-1986. Sixty-five enterprises and subsidiaries—including major banks, insurance companies, financial holding groups, and industrial groups—were covered by the plan. Considerable progress has been made by way of implementation. Beginning in October 1986, 13 enterprises had been sold by June 1987 with proceeds of over FF 55 billion; the major sales are listed in Table 2. The investment banking group Suez was due to be sold in October 1987, with five other major privatizations, including leading insurance companies and banks, planned to take place before mid-1988.

Some of the problems associated with privatization in the United Kingdom have been largely avoided in France. Except in the case of the glassmaker St. Gobain, market discounts appear to have been small, reflecting the relative ease of valuation given the smaller size of the enterprises involved and the existence of national and international competitors. Partly reflecting the smaller discounts, shareholders have also tended to retain their initial share allocations; as a result, the number of individual shareholders in France has increased fourfold since the privatization program commenced and there has been a substantial mobilization of savings for investment in the stock market. The fact that the proceeds of the sales are to be used to repay debt and to increase the capital of other public enterprises has been particularly welcomed.

Other Countries

Information about privatization in countries other than the United Kingdom and France is mostly sketchy. Table 3 summarizes recent developments in selected countries, focusing on asset sales; other forms of privatization, including the award of foreign management contracts, leasing, and liquidation are more widespread but still remain relatively infrequent events. It appears that only a small number of countries have made significant advances, and that so far privatization is mainly an industrial-country phenomenon. In addition to the industrial countries referred to in Table 3, Canada, the Netherlands, and Spain have privatized some public enterprises. Among developing countries, the achievements of Chile, Malaysia, and Niger appear to be the most extensive in their respective geographical regions. Other countries that have started implementing a privatization strategy include Brazil, Mexico, Côte d'Ivoire, Senegal, Zaire, Bangladesh, the Philippines, Singapore, and Sri Lanka. Perhaps the main feature of privatization in countries other than the United Kingdom is the concentration of sales in the industrial and

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10. The relationship between privatization and performance can only be determined by following a privatized enterprise through a complete business cycle. As Byatt (1985) has remarked about privatization in the United Kingdom: "... we are at an early stage of a major shift in public policy. It will be important to look at this in say, five years' time, by when it should be possible to report on results" (p. 20).
Table 3. Privatization in Selected Industrial and Developing Countries\(^1\)

<table>
<thead>
<tr>
<th>Country</th>
<th>Description</th>
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<tbody>
<tr>
<td>Chile</td>
<td>In the mid-1970s a large number of enterprises taken over by the Allende—Popular Unity—Government were denationalized. More recently, in 1983 the government intervened to prevent bank failures. Two of these banks, Concejonal and Internacional, were capitalized and sold to the private sector in 1986. A third, Colocoladora, was merged with Banco de Santiago. All shares in Banco de Santiago and Banco de Chile, were sold to over 57,000 shareholders. By end-1986, CORFO, the Chilean Development Corporation and its affiliates, sold over 50 percent of the shares of the following enterprises: CHILMETRO (urban transport-metro), CHILQUINTA (electricity distribution), SOQUIMICH (nitrates), and CAP (iron ore). Shares in CTC (domestic telecommunications), ENTEL (international telecommunications), CHILGENER (electricity generation), IANSA (sugar), and LAB Chile (airline), were also sold, although private sector holdings in these companies remain below 50 percent of the total. Shares in the power company, CHILECTRA, have been on sale since 1985.</td>
</tr>
<tr>
<td>Federal Republic of Germany</td>
<td>After a number of small sales, in 1984 the Government received about DM 800 million from the sale of a 14 percent stake in the energy and chemicals conglomerate VEBA. In 1986 it received DM 50 million from the sale of 40 percent of VIAG, the aluminum and chemicals group, and DM 163 million from the sale of 45 percent of IVG, with interests in transportation and property. The remainder of the Government’s holding in VEBA was sold in 1987, for DM 2.4 billion. Forthcoming sales include the Government’s 16 percent share of Volkswagen, more than half its 95 percent share of Prakia-Seismos, an oil and gas exploration company, and some financial institutions.</td>
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<tr>
<td>Italy</td>
<td>In response to widening deficits, a program to strengthen the finances of the major state holding companies—IRI, ENI, and EFIM—was commenced in 1982. Privatization forms part of this program. Thus between 1983 and September 1986 IRI divested itself of enterprises valued at Lit 775 billion, with five banks being sold for Lit 610 billion and an additional Lit 165 billion being raised from the sale of 23 smaller industrial enterprises. Since 1985, IRI has sold holdings in a number of larger enterprises—including STET and SIRTI (telecommunications), SIP (telephone utility) and ALITALIA (airline)—raising Lit 3.410 billion. In addition to selling shares on the domestic stock market, funds have also been raised on London’s Euro-equity market and from IRI employees.</td>
</tr>
<tr>
<td>Japan</td>
<td>In 1985 Nippon Telegraph and Telephone (NTT) was recast as a private stock corporation. Half the total shares (about 6 billion) are in the process of being sold, the completion date for the sale being 1989. The sale proceeds are being used to repay government debt and to finance public investment. The Japan Tobacco Industry became a private stock corporation at the same time, but there are as yet no plans to sell shares. In April 1987, Japan National Railways (JNR) was broken up into several regional companies, in preparation for privatization. In September 1987, a bill to privatize Japan Air Lines (JAL) was approved by the Diet, and the Government’s 43.5 percent shareholding will be sold by the end of the year.</td>
</tr>
<tr>
<td>Malaysia</td>
<td>Since 1985, the Malaysian Government has sold a 49 percent of its holding in Malaysian Airline System Berhad, a 17 percent holding in the Malaysian International Shipping Corporation, and half of its holding in the Port Kelang container terminal. There have also been a number of smaller sales. The Telecommunications Department is being prepared for sale over the next two to three years. In addition, the Malayan Railway, the National Electricity Board, and the Postal Department are listed among candidates for future sale.</td>
</tr>
<tr>
<td>Niger</td>
<td>A number of enterprises were privatized in recent years. These include SONIDEP (petroleum distribution), SONITEXTIL (textiles), SOTRAMIL (millet processing), RINI (rice milling), SNCP (hides and skins), LEYMA (insurance), NITRA (freight forwarding), and INN (government printing office). Some sales have been made to Nigerian interests.</td>
</tr>
<tr>
<td>Turkey</td>
<td>In 1984/85, TL 50 billion (US$114 million) was raised by selling certificates entitling holders to a share of the revenue from the Bosphorus Bridge (34 percent) and the Kebean Dam (22 percent). A new dam is being financed in a similar way. In 1987, the Government began to sell its minority interest in a number of small private companies. More extensive privatization is planned, with the petrochemical producer, Petkim, the hotel chain, Turban, and parts of Turkish Airlines among the likely sales.</td>
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\(^1\)A forthcoming World Bank report on privatization will contain a more detailed review of privatization initiatives in industrial and developing countries.

service sectors, with the traditional public enterprises, and in particular the public utilities, remaining largely unaffected. The partial privatization of the Japanese telecommunications company, NTT, and the Malaysian national airline, MAS, represent notable exceptions.

Despite only limited progress, interest in privatization is clearly worldwide. In many countries a principal motive behind actual and planned privatization is to reduce the government resources flowing to the enterprise sector (the Federal Republic of Germany, Spain, Senegal, Niger); a need for additional revenue to secure a reduction in budget deficits is also apparent (Canada, the Netherlands); improving efficiency through promotion of the private sector is often mentioned (Malaysia, Sri Lanka); and in some cases the objective is to reprivatize failing enterprises that have been taken over by the government (Bangladesh,
III • PRIVATIZATION

Chile, the Philippines). In several countries the World Bank Group has promoted privatization as part of its structural adjustment programs. Elsewhere the impetus has been provided by the United States Agency for International Development. While the Fund has supported adjustment programs which refer to privatization, the Fund has not used conditionality as a means of promoting privatization as such.

Notwithstanding the motivation behind privatization and the external support it attracts, there remains a marked divergence between stated intentions and follow-up action. Rather stark examples of this are provided by countries such as Kenya, Jamaica, and Peru, where negligible progress has been made in implementing relatively large programs. Such divergence reflects a variety of factors, including the inevitable gap between ideological rhetoric and a real intention to act. But in many cases it is probably too early to assess the true divergence, since the typical lead time has yet to be established. Seemingly overambitious plans may yet come to fruition, and initiatives being formulated by other countries may also take time to implement. In this respect, practical problems that need to be overcome before a privatization program can be successfully implemented should not be underestimated, especially in developing countries.

Problems of Implementation

The U.K. experience shows that even in a sophisticated financial environment, where shares are routinely traded in large volume and high quality advice can be readily obtained, it is difficult to establish the market value of an enterprise before its sale. A number of factors contribute to this difficulty: the size of the enterprise being sold; the uncertainty regarding the structure of the market in which an enterprise will operate; the impact of any regulatory control that will accompany privatization; and the extent to which the private sector sees opportunities to improve the efficiency of privatized enterprises that the public sector ignores. Undervaluation of assets can be costly. For example, the British Telecom sale may have cost the U.K. Government as much as £3–4 billion in foregone sale proceeds. But with the smaller underpriced issues, the loss has been correspondingly smaller, suggesting that where large share issues are involved, the risk of underpricing can be reduced by selling in small lots to establish a trading price before the majority of shares is placed on the market. This practice is to be adopted when the U.K. Government sells the British Airports Authority: a quarter of the shares are to be sold by tender and then the remaining three quarters will be offered for sale at a price reflecting that established in the sale by tender.

In the case of enterprises that are too small to market in parts, or where an enterprise will be sold directly to a single buyer, valuation will remain difficult. However, one possibility would be to yield control while selling in several phases, with the sale being structured so that long-term financial performance forms the basis for a final valuation, while an interim sale price is based on short-term performance. This would certainly make it easier to sell loss-making enterprises, since no initial sale price need be stated at the time of a change in management, and the ultimate price could take into account any turnaround in performance under private management. If such an arrangement is attractive, there is in fact no need to contemplate changing ownership until an enterprise has spent an extended period under private management. For example, a government could enter a management contract with the private sector, or lease an enterprise to the private sector, for a number of years prior to sale.

Valuation problems are compounded in developing countries. In many cases neither the private sector of the economy nor the capital market is sufficiently developed to yield even an approximate valuation. While international markets could help in this respect, the restrictions that are often placed on the involvement of foreigners and nonresident nationals limit this possibility. And even where a market value can be established, the thinness of domestic capital markets necessarily places limits on the ability to finance privatization from domestic resources. In the United Kingdom and other industrial countries there are large, well-established capital markets. Many developing countries, particularly in Africa, do not have a stock market, and those that do exist are often very small. In Peru, for example, the privatization program was never implemented because the planned asset sales (equivalent to about 3 percent of GDP in the early 1980s (Berg, 1983)) were too large in relation to available private sector resources.

In this respect, an advantage of privatization, by necessity only on a small scale initially, is that it may promote the development of indigenous capital markets. Any increase in the range of assets available to domestic savers may lead to increased saving and to the substitution of shares in privatized enterprises for cash holdings, and real and foreign assets. In Turkey, for example, the sale of bonds secured by revenues from the Bosphorus Bridge and the Keban Dam, financed largely by gold sales, is claimed to have been a major influence on the growth of the capital market. As in the Turkish case, a minimum income may have to be guaranteed to shareholders to induce them to participate in a market where the availability of, and access to, information is necessarily limited. This is especially important in developing countries where there is

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11 This statement is based upon the difference between the offer price and the market price of shares actually traded; however, a sale by tender may not have achieved 100 percent premium on the actual offer price and a much higher fixed price offer may not have been fully subscribed.

12 Even in industrial countries, except for the major ones, stock markets rarely have turnovers in excess of $5 billion. The financing problem is not therefore limited to developing countries.
the risk that profits will be squandered rather than distributed to shareholders.

If the domestic capital market cannot be sufficiently developed, other alternatives will have to be explored. For example, an often neglected source of finance is the workforce of an enterprise. A privatization package could be set up allowing workers to receive shares in an enterprise in return for agreeing to repay the government, or to relinquish a claim against it. In practice, this could mean that a share of wages would go to the government for a specified period. In effect, the government would be bearing part of the operating risk even after privatization—it would not receive full payment if the enterprise failed—and this could be seen as a way of compensating for informational inadequacies. Alternatively, workers could give up their termination benefits or part of their accrued pension rights, which in many cases would be greater than if they had worked in the private sector.

Debt-to-equity conversions also offer a potential source of finance. A number of Latin American countries, most notably Argentina, Brazil, Chile, and Mexico, are allowing foreign banks to exchange debt for equity. Typically, the foreign creditor will sell debt to a third party seeking an equity position in the country concerned. The debt is sold at a discount in the secondary market, but a participating bank benefits because it divests itself of a possibly troublesome loan and can reorganize its portfolio. The debtor government will convert the debt into domestic currency as long as the proceeds are used to finance approved local investment; this will directly serve growth and other development objectives. Such a procedure also reduces a country’s external debt burden without drawing on scarce foreign exchange. The investor—often a multinational company—also benefits from the reduced effective exchange rate at which local assets are acquired. These advantages—which may or may not wholly materialize—combined with the fact that public enterprise debt forms a large share of total external debt in developing countries, can facilitate the privatization process.

One of the objectives of privatization in the United Kingdom has been to widen the ownership of shares, so the issue of proper marketing is important. As indicated above, the initial results of the U.K. Government’s attempts to encourage share ownership by individual investors were poor as individuals sold out their holdings mainly to the financial institutions. In part, this reflects the bias of the U.K. tax system against individual saving and in favor of collective saving (see Kay and King (1983)). But it is mainly a reflection of the profits to be made by purchasers as a result of the underpricing of shares. Despite continued underpricing, privatization has recently achieved greater success in securing wider share ownership as shareholders have responded to incentives designed to discourage quick sales. Moreover, in the 1986 budget, the U.K. Government introduced a personal equity plan giving tax incentives to hold shares.

Many developing countries, by contrast, wish to limit participation to particular groups of shareholders and, to this end, exclude potential buyers. In addition to foreigners and nonresident nationals, ownership by certain ethnic or social groups is often unacceptable. This may be a principal reason why privatization is proceeding so slowly. Brazil, Kenya, and Malaysia are countries where restrictions on desirable shareholders have been a major impediment to privatization. But these restrictions are not found exclusively in developing countries. For example, Japan is not allowing foreign purchases of shares in the telecommunications company, NTT. Also, both the British and French privatization programs have, formally or informally, imposed restrictions on foreign ownership.
IV Privatization and Competition Policy

Proponents of privatization argue that transferring public enterprises to the private sector will expose these enterprises to the discipline of the market, and thereby lead them to increase efficiency.

Privatization and Efficiency

How can privatization be expected to make public enterprises more efficient? To answer this question, we need to distinguish between public enterprises that are already subject to national or international competition and those in a monopolistic position, by which is meant either total monopoly power or near-complete insulation from the pressure of competition.

In the first case, the forces of competition should provide the incentive for enterprises to seek out opportunities to increase both productive and allocative efficiency. In general, there are no strong grounds for public ownership of such enterprises, and sale to the private sector should be both straightforward and uncontroversial. Of course, some enterprises will have survived competition only with budgetary support. There may be compelling reasons why this support should continue—where enterprises have social obligations or where they serve strategic interests, for example—but, otherwise, it seems appropriate that commercial considerations should determine the viability of such enterprises.

Clearly much of the privatization that has occurred, both in industrial and developing countries, falls into this first category. It will have led, or is likely to lead, to some gains in efficiency, but the aggregate impact of such privatization is necessarily small, given previous exposure to competition under public ownership, and the fact that, in general, competitive firms account for only a small share of the public enterprise sector. The greatest benefits resulting from the privatization of such enterprises probably derive from the initial momentum given to a privatization strategy and the release of human resources which can be directed toward supervising the remaining public enterprises. However, large efficiency gains can be expected to come only from the privatization of public monopolies, and in particular large monopolies. To the extent that privatized enterprises are able to retain most of their monopoly power—either because statutory protection continues or because their cost structure implies that they are natural monopolies—the scope for improvements in efficiency relates primarily to what can be done to enhance productive efficiency. There is no reason to believe that the product mix produced by a private monopoly is valued more highly by consumers than that produced by a public monopoly, in which case no improvement in allocative efficiency is likely to emerge from privatization.

When a public monopoly is transferred to the private sector, the privatized monopoly will typically have to accept regulatory surveillance. In the United Kingdom, the privatization of British Telecom was accompanied by the creation of a regulatory agency, OFTEL (Office of Telecommunications), in recognition of the monopoly position to be retained by British Telecom. The recent sale of British Gas has seen the creation of a similar agency, OFGAS (Office of Gas Supply). The privatization of major monopolies should therefore be seen as involving a change in the nature of regulation (Rees (1986)).

A number of different arguments suggest that the replacement of a public monopoly by a regulated private monopoly will increase productive efficiency. Of these, three—the impact of reduced political interference, a change in property rights, and more effective financial management—should be emphasized.

Reduced Political Interference

If public enterprise managers cannot make decisions independently of the need to meet the demands of political expediency, privatization should improve the quality of managerial decision making. The record of political interference in the operation of public enterprises is bad, and the fact that governments in many cases retain a controlling interest in privatized enterprises implies that considerable scope for political interference will remain, even after privatization. However, in attempting to exercise this power, politicians are likely to face two constraints.

The first constraint is the regulatory framework, which is concerned not only with policing anticompetitive practices, but also with eradicating other sources of economic inefficiency, including attempts by politicians to affect economic decisions. To be effective, the regulatory agency should be invested with sufficient autonomy to limit the possibility of it being captured by particular interest groups. The second constraint is the existence of private shareholders, who can monitor the conduct and performance of the enterprise. While, in effect, every
taxpayer/voter is currently a shareholder in the public enterprise sector, an explicit shareholding may induce those voters who hold shares to take a greater interest in the performance of public enterprises; politicians may therefore be required to act more responsibly as a result of privatization. Of course, if ownership is widespread this may not be an effective constraint. There might be better control if the majority of shares were in the hands of major financial institutions, which of necessity must monitor their investments very closely, indeed, this is one reason individuals prefer to hold shares in financial institutions rather than in specific companies. The resulting concentration of share ownership, however, is inconsistent with the object of achieving broad-based share ownership.

Changing Property Rights

It has been suggested that a change in ownership will affect the structure of property rights and thereby overcome existing bureaucratic failures. Shareholders will be aware of the possibility of takeover, and will set up incentive systems—featuring bonus payments or profit sharing, for example—that put pressure on managers to be more efficient. While shareholders may be better informed and more demanding principals than government because they share more directly the benefits and costs of the way a firm is managed, if the structure of operational control is largely unaffected by a change in ownership, there may remain a problem of asymmetric information. Thus, property rights theory suggests that managers of private monopolies are also able to take out part of the benefit a monopoly confers in the form of a quiet life. In addition, because private managers typically have greater discretionary power than public managers, they can, according to the theory, take advantage of the opportunity this presents to pursue goals that promote their own position and reputation, and so increase their personal rewards.

More Effective Financial Management

Upon privatization, an enterprise should relinquish access to direct financial support from the government. It will, therefore, be subject to the discipline imposed by the private capital market and the market for corporate control. The effectiveness of this financial constraint will depend upon the government’s resolve in resisting claims for direct support, or indirect support in the form of preferential treatment by the private capital market backed by an explicit or implicit government guarantee.

Although none of the above arguments unequivocally implies that privatization will significantly increase productive efficiency, some improvement is likely to result. While politicians may continue to interfere in privatized enterprises and while inefficient enterprises can satisfy their creditors and not be threatened by takeover, private monitoring of managers is probably more effective than public monitoring. Also, without the financial backing of government, the capital market will impose some pressure on enterprises to be efficient. Even so, substantial efficiency gains may well fail to be realized. Moreover, even if productive inefficiency is reduced considerably, allocative efficiency may be conceded in the process, and the actual gains in economic efficiency resulting from a change in ownership may prove relatively modest. The size of likely efficiency gains cannot, however, be determined a priori, nor is there sufficient quantitative information on which to base a judgment.

Privatization and Liberalization

While changes in ownership may be expected to produce some gains in productive efficiency, there is no reason to expect improvements in allocative efficiency. Allocative efficiency is a function of market structure rather than ownership. In the initial absence of competition, gains in allocative efficiency can be expected only if privatization is accompanied by liberalization policies to remove market restrictions. Moreover, the pressure of competition, which requires private enterprises to seek out opportunities to make profits in order to minimize the risk of takeover, rather than changes in ownership, may be a more significant source of productive efficiency. Given the importance of competition, the question then arises as to the relationship, if any, between privatization and liberalization.

A number of arguments suggest that liberalization cannot proceed successfully without privatization. The most important economic argument relates to the possibility of predation. A public enterprise, backed by government resources, may be able to engage in practices designed to deter new entrants, for example by reducing prices to close to or below costs. Predation can obviously coexist with liberalization in the public sector, as in the case of coach transport in the United Kingdom (see Rees (1986)). But predatory practices are more likely to occur in the private sector—indeed, it is in the context of business strategy in the private sector that predation has been a major issue—and this has been recognized in the formulation of regulatory policy in many countries. While the possibility of predation does not imply that privatization is necessary for liberalization, it does suggest that liberalization is unlikely to foster competition successfully unless accompanied by regulation to deter anticompetitive practices. In the case of public enterprises, this may require cutting off access to government financial resources to finance such practices.14

Further, while liberalization with appropriate regulation

13This is simply the other side of the argument for and against public ownership, namely that it is necessary to improve allocative efficiency, but productive efficiency is conceded in the process. For an illustration relating to medical care in the United States, see Klein (1984).

14See Vickers (1985) for further discussion of predation.
economic efficiency, if publicly owned competitive enterprises are assured of financial support from the government, they may lack incentives to seek productive efficiency. Competition among private enterprises secures full economic efficiency. When publicly owned enterprises compete in the market, economic efficiency can be maintained only if the government, while retaining ownership, requires such enterprises to remain commercially viable. If such a condition is not imposed, liberalization and regulation are unlikely to be fully effective without privatization.

While other considerations—such as political expediency—might suggest that liberalization is to a degree dependent on privatization, considerations relating to predation suggest that liberalization can proceed without privatization. But to maximize efficiency gains (subject to the qualifications outlined in the next section), privatization and liberalization (accompanied by appropriate regulation) are desirable, although, under some circumstances, it may not be in the government's interests to pursue both. For example, one of the objectives of privatization may be to generate budgetary resources. Clearly, the market value of an enterprise is determined by its current and future profitability. Governments, therefore, may be motivated to protect privatized enterprises from competition to boost their market valuation. It has been argued that this was the case with the privatization of British Telecom in the United Kingdom, where competition was also resisted by incumbent management (Kay and Silberston (1984)). The restriction of competition to boost budgetary revenue, to placate management, or to meet other short-term objectives, has potentially long-term implications; it makes any future introduction of competition difficult in that this might lower the value of shares in privatized enterprises (Kay and Thompson (1986)). Therefore, as a general rule, where privatization and liberalization come into conflict, the latter should be preferred since privatization can more readily follow liberalization than vice versa.

**Competition and Efficiency**

It has been argued that, where increased efficiency follows privatization, it results from a consequent increase in competition rather than from a change in ownership. This in turn suggests that the scope for enhancing efficiency through privatization is limited by the extent to which markets can be made more competitive. Among the factors that may constrain market competition, three stand out. First, public enterprises often owe their existence to market failure and, this being so, opening up a market to competition may achieve little, or may even prove counterproductive. For example, where a public enterprise is a natural monopolist, opening up a market is unlikely to attract competition, and privatization may result in a monopoly position being more fully exploited. Second, competition may not be appropriate, especially when enterprises cross-subsidize loss-making activities—a situation that often arises when enterprises have significant social and other noncommercial objectives—and the private sector can engage in "cream-skimming." In such circumstances, the private sector will undertake only profitable activities; the public sector will be left with loss-making activities, for which budgetary support will be required unless concessions are made in respect of social objectives. The third factor that may limit competition is the difficulty of designing effective regulatory regimes. These issues are discussed in more detail below, following a discussion of contestability.

**Contestability**

It is important to note that full competition is not essential to achieve desired efficiency: the threat of competition may be sufficient. Much has been made of an argument based upon the theory of "contestable markets" (Baumol, Panzar, and Willig (1982)), according to which a monopolist is said to operate in a contestable market when his behavior approximates that of a competitive firm. Such a situation exists only in the absence of entry restricting barriers to exit; in other words, sunk costs must be low. If such a condition holds, and if a monopolist is behaving as if he were not subject to competition, then other firms can raid the industry for part of the monopoly profit. It is therefore the fear of entry that induces the monopolist to keep prices close to costs. For the traditional public monopolies—that have large capital investments that cannot be recovered on exit—contestability is unlikely to be relevant. However, it could be more significant if the public enterprise sector contains many smaller commercial enterprises, although even when this is the case, it is difficult to think of many activities for which the assumption of costless exit is appropriate. 

**Natural Monopolies**

The efficiency gains resulting from competition policy in a market dominated by a natural monopolist are restricted by the limited opportunities for new entrants. The core activities of these enterprises tend to resist competitive pressures, and a change in ownership through privatization will involve no more than a change in the form of regulation, with little expected impact on economic efficiency. A flexible approach to privatization may, however, stimulate competition in a natural monopoly setting, and thereby promote both productive and allocative efficiency. As described in Section III, privatization need not involve a sale of public sector assets, and other forms of privatization may create an environment of contestability. Although natural monopoly tends to be defined by the core

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activity—in particular, access to a network such as an electricity grid—many associated activities, such as maintenance, can be contracted out to the private sector through competitive bidding. Contracting out is perhaps the most common form of privatization, having been widely used in the local public services (such as refuse collection, catering, cleaning and laundering in hospitals).

In the case of natural monopoly, franchising offers some interesting possibilities (Kay and Silberston (1984)). A franchise involves inviting the private sector to compete for the right to operate a natural monopoly. Franchising is probably more appropriate where a natural monopoly can be decentralized, since it is better, in terms of efficiency, to have small rather than large monopolies operated by the private sector. For example, many network services can be partly operated on a regional basis. In order to maximize productive and allocative efficiency, franchises could be awarded on the basis of price and service offered rather than, as is customary, of payments made by the franchisee to the government. A need for extensive regulation will nevertheless remain to ensure that franchisees meet their obligations. In addition, unless entry costs are low, a franchisee is in a strong position either to amend the contract or disregard it. Franchising is also particularly susceptible to abuse. Thus, in practice, franchising is likely to have limited appeal, and activities that tend toward natural monopoly will probably continue to be undertaken by the public sector.  

Social Objectives

If an enterprise has social or other noncommercial objectives, efficiency is necessarily sacrificed and often losses are incurred. In principle, if these objectives are sufficiently compelling it should be possible to accommodate them—especially those that involve subsidies—as part of both privatization and procompetition strategies. For example, the government could contract with the private sector to deliver essential services, keep prices below costs, and provide employment. Private sector suppliers could bid for a government subsidy, in return for which they would guarantee that the above requirements were met. However, any attempt to replace subsidies that are only implicit in existing arrangements with explicit subsidies that draw attention to the cost of meeting a particular objective are likely to face strong resistance. In addition, placing a value upon social objectives is a subjective exercise, fraught with conceptual and technical difficulties, and one that is likely to encounter strong political opposition.

Public ownership will continue to be used to further certain social objectives, although with some loss of efficiency that may call into question the cost-effectiveness of pursuing these objectives. A rigorous cost-benefit analysis of all such objectives is clearly impossible. While in some cases it will not be possible to meet urgent social priorities as effectively and efficiently by other means, there will be other cases that, even without any detailed technical analysis, will be clearly ill defined, inappropriate, and noncost-effective. However, a large grey area—comprising objectives on whose importance there is little agreement—will inevitably remain.

Regulation

It has been pointed out that regulation is an essential component of effective competition policy. Where competition is admissible (other than in the case of natural monopolies), liberalization will result in the removal of barriers to competition, such as statutory monopoly and other forms of protection. Of course, the removal of such barriers will not necessarily lead to an increase in competition. Monopolistic enterprises in both the public and private sectors, especially if they are large relative to the size of the potential market, can erect strategic price and nonprice barriers. Therefore, an appropriate regulatory regime is crucial. However, the design and enforcement of regulations in the private sector have proved difficult. It is well known that predation is difficult to establish. Often, regulators do not have sufficient information to decide whether a particular activity is anticompetitive. Moreover, once an anticompetitive practice has been identified, it may take so long to curtail that it will already have had its intended effect. Regulators' decisions may also be influenced by pressure groups, by the government or the enterprise itself.

Clearly the impact of competition policy—and privatization—on the efficiency of privatized enterprises with dominant positions in potentially contestable markets will depend upon how well the regulatory regime functions. Indeed, the success of the current shift in the emphasis of industrial policy toward private competition depends largely on the effectiveness of regulation. The design of appropriate regulatory regimes will not be discussed here, although it should be noted that public ownership, despite its shortcomings, is judged by some to have proven a relatively efficient way of regulating monopolies (Papps (1975)), especially in the case of natural monopolies and elsewhere that markets are unlikely to be contestable.

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16 This has been a general problem in the case of cable television in the United States.
17 For a more detailed discussion on franchising, see Sharpe (1983).

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Fiscal Impact of Privatization

In a number of countries, privatization has been mentioned in the context of general measures intended to secure a reduction in the government or public sector deficit. The fiscal impact of privatization is, however, less obvious than the act of selling an enterprise or eliminating the need to subsidize loss-making enterprises would seem to suggest.

Asset Sales in Government Accounts

Recommended Fund practice, as described in its Manual on Government Finance Statistics, is to treat the proceeds from asset sales to the private sector as either capital revenue or a loan repayment in government accounts. If the government sells fixed assets previously held for its own use, land, or intangible assets such as mineral rights, the sale proceeds are recorded as capital revenue. If the government sells part or all of its interest in a public enterprise, the transaction is treated as a sale of equity and the proceeds are recorded as a loan repayment. These conventions apply when considering both the government accounts (either central government or general government) and the public sector accounts (which reflect the consolidation of general government and the public enterprise sector).

As in the earlier discussion, asset sales will be equated with sales of public enterprises. In an accounting sense, the immediate fiscal impact of an asset sale is straightforward: if there are no other budgetary changes, the overall deficit—that is the difference between total expenditure and total revenue—will be reduced by an amount equal to the sale proceeds. To the extent that the timing of an enterprise sale implies that revenue in the form of profit normally remitted to the government by an enterprise is forgone in the year of sale, the reduction in the government overall deficit will be lower by the amount of this unremitting profit.

This means that in general asset sales would tend to lead to a once-and-for-all reduction in the overall deficit unless the sale price was less than income that would have accrued to the government. In practice such an outcome would be possible if a firm had sufficiently large liabilities that future discounted earnings were negative while current earnings were positive, but such an enterprise would probably be a candidate for liquidation rather than privatization.

The overall deficit provides a guide to a number of aspects of the relationship between government activities and the economy as a whole. Most importantly, since the deficit measures the difference between government expenditure and government revenue, changes in the overall deficit, after suitable adjustments, are often regarded as indicating changes in the government's fiscal stance, and especially whether demand management policy has become more expansionary or contractionary. In addition, since the government must borrow to finance the overall deficit, its size has monetary and associated financial policy implications. The size of the overall deficit, and the way in which it is financed, also has balance of payments consequences. This section focusses on the overall deficit as an indicator of fiscal stance in the context of asset sales, and discusses briefly their financial implications and their impact on the balance of payments.

Asset Sales and Fiscal Stance

Assume that a public enterprise is sold to a private buyer at a fair market price. Such a price is defined as being equal to the present value of the discounted stream of after-tax net earnings of the enterprise, assuming that tax liabilities are the same both in the public and private sectors. Further assume that this stream is positive in all future years. As indicated above, all other things being equal, the overall deficit would be smaller at the time of the sale. But the counterpart to this initially smaller deficit will be larger deficits in all future years, reflecting the loss of revenue in the form of remitted profit. However, if the discount rate embodied in the sale price correctly reflects financial opportunity costs, these larger future deficits would be exactly offset if the government used the sale proceeds to purchase other financial assets or to retire an equivalent amount of outstanding debt. In such circumstances, the government and the private sector are simply exchanging financial assets and liabilities, and this should not affect the demand for real resources at the time of sale, or in the future. Fiscal stance is therefore permanently unaffected by the asset sale.

If the government uses the sale proceeds to finance a temporary increase in current expenditure or a temporary

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19 Such adjustments reflect factors such as the phase of the business cycle, the treatment of unemployment compensation, and inflation (see Heller, Haas, and Mansur (1986)).
reliable preliminary guide to fiscal stance, a question counts fail to reflect what is happening to government or ing exclusively on cash flows, standard budgetary ac-
case if enterprises can be run more efficiently in the private
sales are concerned. According to Ashworth, Hills, and
stances the change in the overall deficit is taken as a
sector.
financial dividends to the budget where enterprises are
in many cases may be more logical—offers permanent
changes in performance—as opposed to liquidation which
changed financial assets and liabilities, and fiscal stance
Again, the public and private sectors have simply ex-
will not be affected. The notion that privatization without
will return future deficits to their higher original levels.
larger initial deficit, the need to service the additional debt
will return future deficits to their higher original levels.
Again, the public and private sectors have simply ex-
changed financial assets and liabilities, and fiscal stance
will not be affected. The notion that privatization without
changes in performance—as opposed to liquidation which
in many cases may be more logical—offers permanent
financial dividends to the budget where enterprises are
heavily subsidized, is misleading. This would only be the
case if enterprises can be run more efficiently in the private
sector.
Given that in most frequently encountered circum-
stances the change in the overall deficit is taken as a
reliable preliminary guide to fiscal stance, a question
naturally arises as to why this is not the case where asset
sales are concerned. According to Ashworth, Hills, and
Morris (1984), the source of the problem is that by focusing
exclusively on cash flows, standard budgetary accounts fail to reflect what is happening to government or
public sector net worth. Thus, when reference is made to
the government’s balance sheet, it is clear that if an asset
sale involves a change in the composition of assets but net
worth is unaffected, then despite resulting changes in
deficits such a transaction has no fiscal impact. Similarly,
when the sale proceeds are used to finance current expend-
diture or reduced taxation, and there is no change in the
deficit, the resulting reduction in net worth indicates the
initial expansionary impact of the transaction, and the
consequential need for subsequent contraction, to com-
pease for the income that would have been generated by
the lost wealth.
In suggesting that attention should be paid to the net
worth of government in assessing the fiscal impact of asset
sales, any implication that it is necessary to construct a full
balance sheet where future impact of all government ac-
tivities is represented in present value terms is not in-
tended. Such an exercise raises methodological and practi-
cal problems that would make it an enormous, and in many
cases fruitless, undertaking. Nevertheless, an exercise of
this sort has been advocated, and partially completed, by
others, for example Butler (1983a, 1983b), and Ashworth,
Hills, and Morris (1984), with a view to determining,
amongst other things, whether government consumption
is consistent with estimated net worth. The requirements
of the aforementioned exercise are more modest. There is
no suggestion that the overall deficit be attached any less
significance than is the current practice. Rather, the sug-
gestion is that in certain circumstances additional informa-
tion is needed in order to assess the fiscal implications of
budgetary changes. In the case of asset sales, and a wide
variety of other cases, this additional information relates to
the underlying changes in government net worth, or the
extent to which the government is saving or dissaving.

Financial Implications of Asset Sales

If an asset sale is used to reduce the overall deficit, while
other revenues and expenditures are held constant, there
will be no financial impact in the medium term, provided
the asset is sold at market value. As indicated above,
selling an asset is equivalent to borrowing against its
future income stream. However, if the government sells a
bond, it is also borrowing against future income. In both
cases, the government is accepting an obligation to raise
taxes in the future, in the first case to replace a forgone
income stream, and, in the second case, to service debt
repayments. The division of financial flows between the
public and private sectors is not significantly affected by
the form of borrowing (Butler (1983a)). When the sale
proceeds are used to increase current expenditure or re-
duce taxation, bond financing and asset sales are also
equivalent, and in this case future resources have to be
diverted from the private to the public sector to pay for current expenditure increases or tax reductions.  

Asset Sales and the Balance of Payments

The sale of a public sector asset to the private sector cannot, of itself, affect the current account of the balance of payments. As indicated above, the public and private sectors have simply exchanged assets, and this alone cannot influence economic activity. But if privatization raises the overall productivity of the economy, net exports should increase. Also, if the savings and investment behavior of the private sector is adjusted in response to privatization, then the real economy will be affected. However, unless privatization programs are large, the impact of asset sales on the current account is likely to be only marginal.

Qualifications

The above conclusions clearly require modification to the extent that the explicit and implicit assumptions underlying them are inappropriate. Mansoor (1987) explores a range of qualifications in detail. These relate to: the different tax regimes that may confront private and public enterprises; the implications of uncertainty and imperfect markets; discounts implicit in sale prices; and the impact of second-order effects arising from, inter alia, the effect of asset sales on private sector liquidity, on the riskiness of private sector portfolios, and on the capital structure of privatized enterprises. It is shown that the fiscal (and financial) impact of asset sales is potentially quite sensitive to the above considerations, but that few general results emerge. While their precise impact has to be assessed on a case-by-case basis, the analysis does serve to emphasize the basic point that the initial effects on the overall deficit can be misleading in evaluating the impact of asset sales.

A key assumption not mentioned above, but one that requires more extensive discussion, relates to the impact of the sale of an enterprise on its expected income stream. One of the strongest arguments used to support privatization is that an enterprise’s income stream will improve if ownership is transferred to the private sector because of increases in efficiency. Moreover, one of the reasons why governments tend to underprice assets may be that the private sector sees opportunities to improve efficiency that the public sector ignores. These potential improvements in efficiency should, however, be viewed cautiously. They do not arise simply from a transfer in ownership but from concrete actions that raise the productivity of the enterprise or reduce unit costs. Such actions can in principle be taken in either the public or the private sector, and when they occur in the public sector they will directly benefit government and public sector finances. When efficiency gains are judged to be feasible only under private ownership, government and public sector finances will benefit to the extent that the government can share in these gains by setting asset prices to reflect at least part of the improvement in performance and by taxing the higher profits that result. Indeed, in budgetary terms, this should be the whole point of the privatization exercise.

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20In the argument that asset sales are akin to bond issues, all the problems associated with Ricardian equivalence—that is, whether taxation and debt should be treated symmetrically—arise. Barro (1974) contains one of the strongest statements of the Ricardian position. See Atkinson and Stiglitz (1980) for further discussion.
Main Conclusions and Implications for Adjustment Programs

This paper has argued that privatization should be assessed in terms of its effect on economic efficiency. Economic efficiency is not only the key to improving the performance of the public enterprise sector, but is also the source of other gains often attributed to privatization, in particular, its favorable budgetary impact. Many of the other benefits ascribed to privatization—for example, reducing the power of public sector unions and widening share ownership—are unlikely to be related to efficiency gains. And if they are indeed desirable, they can probably more effectively be achieved by other policies, such as trade union reform and tax incentives to promote saving.

To public enterprises that are subject to national or international competition, privatization offers the possibility of increased productive efficiency as government financial backing is withdrawn and bankruptcy and takeover become possibilities. But if a public monopoly is transferred to the private sector with its monopoly power intact, there may be little additional incentive to improve efficiency, although the risk of bankruptcy and takeover may prevent excessive inefficiency in small monopolies. Far more success can be expected if privatization is accompanied by increased competition, and privatization of public monopolies will lead to more competitive or contestable markets only if accompanied by active competition policy. Privatization is neither necessary nor sufficient to create a competitive or contestable market.

The question does arise, however, whether privatization facilitates the promotion of competition. Recent discussions of privatization have certainly increased awareness of competition policy issues. From a political point of view, it may also be easier to liberalize in the context of a privatization strategy. In this context, though, it is necessary to warn against the temptation (observed in some cases) to restrict competition—for example, to make public sector assets more attractive to private buyers—and to note that market failure may prevent the emergence of competition, while in other cases competition may be inappropriate or difficult to enforce. The impact of privatization on economic efficiency in one of the few countries with sufficient history of privatization—the United Kingdom—is difficult to assess. For example, Brittan (1986) concludes that the choice is between "slightly better than nothing" and "slightly worse than nothing." His own verdict is the former, based upon his observation that “faced with the charge of simply creating private monopolies, the Government is impelled to introduce some competitive elements . . . Some moves to promote competition are better than none at all” (p. 38). Does this conclusion necessarily extend to privatization in general, and the impact of privatization in developing countries in particular?

The admissibility and desirability of privatization, as well as what types of enterprise should be privatized, ought to be determined by similar considerations in both industrial and developing countries. However, given the different structure and objectives of the public enterprise sector in developing countries, the character of any privatization program is likely to be very different from that of the United Kingdom, or those programs contemplated by other industrial countries. The excesses of the public enterprise sector—political interference, gross mismanagement, and the proportion of resources devoted to its support—are far greater in developing countries than in industrial countries. Many enterprises are simply not viable and should be disposed of, while a significant proportion of commercial enterprises face or could face competitive pressures, but currently benefit from budgetary support or artificial barriers that protect them from competition, in particular trade restrictions. Unless a strong case, based on social or other noncommercial objectives, can be made for retaining such enterprises in the public sector, privatization, accompanied by the elimination of protection, would appear appropriate. On these grounds, the scope for efficiency-enhancing privatization therefore appears to be greater in developing countries than elsewhere.

As regards public monopolies, privatization is appropriate to the extent that competition can be effectively introduced and private shareholders can motivate managers better than governments. Private ownership is usually presumed to be more efficient, and the evidence, which principally relates to industrial countries, does not contradict this view. In developing countries, however, market failure is usually more prevalent than in industrial countries, and greater importance is attached to social and other

21The issue of priorities is further discussed in general terms by Paul (1985) and in some detail in the United Kingdom context by Beesley and Littlechild (1983).
noncommercial objectives; hence, the relatively large public sectors found in many of these countries. There is only limited scope for privatizing natural monopolies and other enterprises owing their existence to market failure. Also, where enterprises have been used to meet social and other noncommercial objectives, it is unlikely that privatized enterprises can be required to operate according to market criteria without sacrificing some of the more compelling objectives. These considerations would seem to suggest that privatization may be less appropriate in developing countries than in industrial countries.

Whatever the merits of privatization, and the scope for its implementation, it seems inevitable that public enterprise sectors will remain large in both industrial and developing countries and, where opening up the public sector to domestic or international competition is judged difficult or inappropriate, inefficiency will continue to be a problem. In such cases, efficiency can be increased only if enterprises are substantially freed from political interference and existing incentive and control mechanisms are directed toward requiring enterprises, as far as their social and other noncommercial objectives permit, to function along commercial lines and to become financially independent. This will continue to be the main thrust of public enterprise policy.

**Privatization and Adjustment Programs**

Privatization has been mentioned as an element in the structural adjustment efforts of many countries, and to varying degrees this has been addressed in a number of recent programs of the Fund and Bank. Yet it was noted above that, except for the United Kingdom and France, little privatization in general, and denationalization in particular, has actually occurred. Questions therefore arise as to whether privatization should be advocated more forcefully.

This paper has argued that while the economic impact of privatization may be beneficial its net effect, unless measures are taken to promote competition, is probably small. Privatization is therefore likely to be dominated in economic terms by other policies, in particular liberalization and regulation, and more effective variants of the incentive systems and control mechanisms, both statutory and administrative, currently in place. The merits of privatization are thus likely to be influenced by the economic, social, and political factors that are appropriate to the country concerned.

The conclusions of this paper point to the issues that ought to guide national authorities in their discussions of privatization. In particular, one should stress the importance of competition policy and the modest efficiency gains that could result from privatization alone. Where competition already exists, the presumption should be that privatization is appropriate. For public monopolies, the key issue is the extent of the market failure being compensated for. The potential for increased competition, the way in which it is to be secured, and, in particular, the extent to which privatization is consistent with increased competition need to be assessed on a case-by-case basis. It is also important to recognize that privatization ought to reflect a fundamental change in attitude to the conduct of industrial policy.

Privatization, especially in industrial countries, is currently being facilitated by favorable economic developments. By its nature, privatization will result in enterprises having to respond to market forces. Thus, in the event of an economic downturn, the government should be prepared to accept the employment losses, bankruptcy or takeovers that result. If the government instead responds to pressures for intervention (and possibly renationalization), it may find itself in a position where it is bearing costs associated with privatization, in particular sale proceeds that do not reflect the profit forgone in good years, while paying for rescue operations in bad years. Thus the need to ensure that privatization extends beyond a transfer of ownership, and that potential improvements in efficiency are indeed realized, is again emphasized.

Notwithstanding the above reservations and qualifications, privatization should be supported, in all its forms, as a positive step toward dealing with the problems of public enterprises. But to repeat the main point of this paper, privatization must be accompanied by other policies— to promote competition and to improve the efficiency of enterprises that must remain within the public sector—if a significant turnaround in the performance of public enterprises, and the productive sector of the economy as a whole, is to be achieved.
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